Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:BOS:TL-N-1762-01
MJGormley

date:

to: Woody K. Howell, Territory Manager
LMSB (FS)

from: Associate Area Counsel, (LMSB)
Area 1

subject: **Mutual Fund Withholding**
U.I.L. No. 4982.01-00

This memorandum supplements your request for advice dated March 30, 2001, regarding the proper terms of a closing agreement with a mutual fund to correct a prior deficit in withholding on capital gains. We issued a memorandum in response to your request on April 25, 2001. Thereafter, we assisted in the preparation of a letter to the taxpayer's representative, denying their request for a closing agreement under specific circumstances. At the present time, you are seeking our advice regarding an alternative argument being posed by the taxpayer in this case. This memorandum should not be cited as precedent.

ISSUE

Whether the I.R.C. § 4982(f) exception to the excise tax imposed on certain undistributed income of regulated investment companies (RICs) under I.R.C. § 4982(a), may be applied to the RIC's shareholders on a pro rata basis.

CONCLUSION

In order for the I.R.C. § 4982(f) exception to apply, all of the RIC's shareholders must qualify as pension, profit-sharing or stock bonus plans described in § 401(a) or the segregated asset accounts of life insurance companies held in connection with the variable contracts defined in § 817(d). I.R.C. § 4982(f) may not be applied on a pro rata basis.

FACTS

The facts set forth below, and upon which this advice is based, are as stated by your office in your memorandum dated March 30, 2001, as supplemented by a letter from the taxpayer's representative dated April 11, 2001, and as described in an additional memorandum from your office dated August 16, 2001. If our understanding of the facts is not correct, or if the facts have changed in any way, you should not rely on this advice but rather seek modified advice based on the changed circumstances.

Based on the facts initially presented by the taxpayer's representative, a regulated investment company (RIC) made an error in its year-end capital gains distribution to its shareholders for the calendar year [redacted]. The RIC had a required distribution of capital gains income of approximately $[redacted]. Due to an arithmetic error, it distributed approximately $[redacted]. This left an undistributed capital gain in the amount of $[redacted]. Shareholders in the mutual fund, the RIC, included fully taxable shareholders and tax deferred shareholders, such as I.R.C. § 401(k) plans, IRA's and the like. Based on the taxpayer's review, approximately [redacted]% of the shareholders in the fund would currently be subject to tax. Therefore, of the $[redacted] of undistributed capital gain, only [redacted]% or $[redacted] would be subject to tax at capital gains rates. Assuming a full capital gains rate of 20%, the underpayment of tax totals approximately $[redacted].

As a result of this underreporting error, the RIC is subject to a 4% excise tax imposed by I.R.C. § 4982. Initially, it was also thought that the RIC was subject to information return penalties under I.R.C. § 6723 for failure to include correct information on its payee statements. However, the taxpayer's representative now claims that the payee statements or Forms 1099 were in fact correct.[1] The only item at issue is the RIC's failure to distribute the full amount of the capital gains to its shareholders.

The RIC initially proposed it be allowed to enter into an agreement with the Service whereby it would make a compliance

---

[1] In order to resolve the underreporting issues, the RIC initially proposed entering into a closing agreement (Form 906) with the Service whereby the RIC will be charged interest from [redacted] to [redacted] for the unreported capital gain. It would distribute the capital gain in the year [redacted] and the recipient shareholders would report their respective portion of the gain on their individual returns in [redacted]. The representative for the RIC implied the Service would not then require the RIC to file an excise tax return and report the 4% penalty.

contribution to the Service to insure that "the Treasury is made whole for any loss on the timing of the payment of capital gains tax," in exchange for relief from any additional tax or penalties. Your original request for advice was whether the use of a Form 906 closing agreement was the proper procedure to use in order to resolve these issues. You also sought our opinion regarding the substantive content of the closing agreement. We concluded that if the threshold requirements of the Information Reporting Program Closing Agreement Procedures were met, the mutual fund could enter into a closing agreement (Form 906) with the Service wherein it agreed to pay a compliance fee, computed at a rate of 31%, applied to the total amount of understated reportable income. This payment would be in lieu of tax, interest and any potential penalties.

The RIC rejected this proposal and instead sought to pay a compliance fee composed of only interest. Notably absent was any proposed payment in lieu of the required tax and applicable penalties. No responsibility for payment of penalties was assumed and the responsibility for payment of the tax due remained with the shareholders of the RIC, and was to be remitted in the year subsequent to the error. It was determined that this subsequent year payment would permit an improper deferral of income between years and would also make the closing agreement dependent upon the promise of performance of a future act. Your office concluded that the closing agreement as proposed would not provide a permanent and conclusive resolution of the issues and the taxpayer's proposal was rejected.

The taxpayer's representative now asserts that although the RIC may be responsible for the 4% excise tax under I.R.C. § 4982(a), this tax should not be computed at the entity level. Rather, the taxpayer asserts that I.R.C. § 4982(f) provides for an exception to this penalty and that the exception is applicable to the facts of this case. The taxpayer claims that this exception applies because approximately [redacted]% of the underlying shareholders are tax deferred entities and the 4% excise tax should be calculated against only the remaining [redacted]% of the shareholders' capital gains.

Legal Analysis

A regulated investment company (RIC) is generally treated as a conduit for income tax purposes. The RIC's taxable income, which is distributed to investors each year, is taxed to them without being taxed at the entity level. This is accomplished by allowing the RIC a deduction for distributions paid to its shareholders. RICs can generally deduct dividends paid to shareholders from investment company taxable income and net capital gains. If RICs meet certain requirements, they can pass through the character of certain types of income and deductions. Capital gains and net tax-exempt interest income may retain their character when distributed to shareholders. I.R.C. §§ 852(b)(3)(B) and 852(b)(5)(B).

To qualify for conduit treatment, the RIC must distribute at least the sum of: (1) 90% of its investment company taxable income for the tax year determined without regard to capital gain dividends and exempt interest dividends, and; (2) 90% of the excess of its exempt interest income over the expenses, including amortization of bond premium, of earning the exempt interest. I.R.C. § 852(a). When an investment company fails to satisfy the distribution requirements, it is ineligible to take the dividends-paid deduction and is taxed on its net investment company taxable income and net capital gains as a C corporation. In addition, failing to satisfy the distribution requirement prevents the fund from passing through capital gains, exempt interest dividends, dividend income qualifying for the dividends-received deduction, or foreign taxes to shareholders.

An excise tax is imposed on certain undistributed income of a regulated investment company (RIC)in accordance with I.R.C. § 4982(a). This provision was enacted by Congress in order to limit the ability of RICs to achieve deferral of income for their shareholders. See Rev. Rul. 94-40, 1994-1 C.B. 274, citing H.R. Conf. Rep. No. 658, 94th Cong., 1st Sess. 360-62 (1975), 1976-3 (Vol. 2) C.B. 1052-54 (§ 4981); S. Rep. No. 313, 99th Cong., 2d Sess. 261 (1986), 1986-3 (Vol. 3) C.B. 261 (§ 4982). Prior to the enactment of I.R.C. § 4982, there was no federal tax detriment to a RIC that delayed payment of dividends under I.R.C. § 855.

The ability of RICs to defer their distributions is limited by I.R.C. § 4982, which defines the amount the RIC is required to distribute during the calendar year and imposes the tax on the amount the RIC fails to distribute. The tax is equal to 4% of the excess of (1) the required distribution for the calendar year, over (2) the distributed amount for the calendar year. The tax is payable on or before March 25 of the following calendar year.[2] The required distribution is the sum of 98% of the RIC's ordinary income for the year, plus 98% of the RIC's capital gain net income for the one year period ending on October 31 of the calendar year. I.R.C. § 4982(b)(1). This is increased by any

[2] Form 8613, Return of Excise Tax on Undistributed Income of Regulated Investment Companies is to be used by RICs to report the excise tax.

excess of grossed up required distribution over the distributed amount for the preceding calendar year. I.R.C. § 4982(b)(2). For purposes of this subsection, the term grossed up required distribution for any year is the sum of the taxable income of the RIC for the year and all amounts from earlier years that are not treated as having been distributed under this provision. I.R.C. § 4982(b)(3).[3]

In order to compute the amount of net capital gain that must be distributed by a RIC so as to avoid the excise tax imposed by I.R.C. § 4982, RICs are allowed to offset their net capital gains by their net ordinary losses that were incurred during the same year. Such losses are generally equal to a RIC's net operating losses. However, when a RIC has not made an election to use its own tax year for purposes of computing the excise tax, and if the RIC's tax year does not end on October 31, the RIC's earnings and profits for such purpose will be determined without regard to any net capital losses or net foreign currency losses attributable to transactions occurring after October 31. I.R.C. § 4982(e)(2).

I.R.C. § 4982(f) provides for an exception from the above-described excise tax. This exception applies to a RIC that is "predominately owned by specific entities whose receipt of distributions from the RIC would not give rise to tax liability. The tax does not apply to any RIC for any calendar year if all its shareholders at all times during such year were qualified pension trusts or segregated asset accounts of insurance companies held in connection with variable contracts. Shares attributable to an investment of less than $250,000 made in connection with the organization of a RIC will not prevent the RIC from qualifying for this exception." Technical and Miscellaneous Revenue Act, Pub. L. No. 100-647, II. Explanation of the Bill, Title I. Technical Corrections to the Tax Reform Act of 1986, VI. Corporate Tax Provisions, J. Regulated Investment Companies.

In order to qualify for this exception, the plain language and legislative history of the Code section make clear the exempt organization must be a qualified pension, profit-sharing or stock bonus plan described in Code § 401(a) and exempt from taxation under Code § 501(a) and the segregated asset account of a life

---

[3] The distributed amount under this provision is the sum of the dividends paid deduction during the calendar year and any amount taxed to the RIC as investment company taxable income or capital gains. This amount is increased by the distributed amount for the preceding calendar year to the extent that it exceeds the grossed up required distribution for that year.

insurance company must be held in connection with variable contracts defined in I.R.C. § 817(d). Internal Revenue Code § 4982(f) reads as follows:" This section shall not apply to any regulated investment company for any calendar year if at all times during such calendar year each shareholder in such company was either - (1) a trust described in I.R.C. § 401(a) and exempt from tax under I.R.C. § 501(a), or (2) a segregated asset account of a life insurance company held in connection with variable contracts (as defined in I.R.C. § 817(d)). For purposes of the preceding sentence, any shares attributable to an investment in the regulated investment company (not exceeding $250,000) made in connection with the organization of such company shall not be taken into account." This exception was added by amendment to I.R.C. § 4982, as part of the technical corrections to the Tax Reform Act of 1986 and other 1986 tax legislation, introduced in the 100th Congress in June 1987. Technical and Miscellaneous Revenue Act, Pub. L. No. 100-647, § 1006(l)(6). The technical correction titles contained clerical, conforming and clarifying amendments to the provisions enacted by the Tax Reform Act of 1986. All amendments were meant to carry out the intent of Congress in enacting the original legislation. Technical and Miscellaneous Revenue Act, Pub. L. No. 100-647, II. Explanation of the Bill, Title I.

The taxpayer now argues that this exception, applicable to the specific types of RICs described above, should be applied on a pro rata basis. Specifically, that the plain language of the Code, requiring that *each* of the RIC's shareholders at all times during the year be qualified pension trusts or certain segregated asset accounts of insurance companies, should be disregarded and the exception applied to that percentage of its shareholder that are tax deferred and would arguably, otherwise, qualify. "...[T]he starting point in every case involving construction of a statute is the language itself." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring). See also Teamsters v. Daniel, 439 U.S. 551, 558 (1979). In looking to the language in the statute, unless otherwise defined, words are given their ordinary, common meaning. Perrin v. United States, 444 U.S. 37, 42 (1979). It is well settled that if a statute is neither vague nor ambiguous, the plain meaning of the statute should be followed. United States v. Nardone, 302 U.S. 379, 383 (1935). The assumption is that the legislative purpose is expressed by the ordinary meaning of the words used. Richards v. United States, 369 U.S. 1, 9 (1962). See also United States v. American Trucking Ass'n, 310 U.S. 534, 542-43 (1940). However, if the statute is facially ambiguous, its legislative history should be consulted. Id.; American Tobacco v. Patterson, 456 U.S. 63, 68 (1982). In this case neither a plain reading of the statute nor its legislative history support the taxpayer's argument.

In applying the plain meaning rule and using the ordinary meaning of words, the meaning of the word "each" denotes every one of a group considered individually. Heritage Dictionary 434 (2^{d} ed. 1985). The legislative history of the statute supports the ordinary meaning of the term. See Miscellaneous Revenue Act of 1988, House of Representatives; Report 100-795; 100^{th} Congress 2d Session. See also Technical Corrections Act of 1988, Senate Report 100-445; 100^{th} Congress 2d Session; S. 2238 ("The bill creates an exception to the excise tax under section 4982 when the RIC is owned predominately by specified entities whose receipt of distributions from the RIC would not give rise to tax liability. The tax does not apply to any RIC for any calendar year if all its shareholders at all times during such year were qualified pension trusts or segregated asset accounts of insurance companies held in connection with variable contracts."); Committee on Finance, Rept. No. 100-76; 100^{th} Congress; 1^{st} Session; H. Con. Res. 93 ("The bill creates an exception to the excise tax where the RIC is owned mostly by specified tax-exempt entities. The tax does not apply to any RIC for any calendar year if at all times during such year, all its shareholders were certain segregated asset accounts of insurance companies or qualified trusts."); description of the Technical Corrections Act of 1988, Joint Committee print; H.R. 4333 and S. 2238; JCS-10-88; and, House of Representatives, Rept. 100-391; 100^{th} Congress; 1^{st} session; H.R. 3545. There is no support in the legislative history for the taxpayer's pro rata argument.

Conclusion

Based on the facts you have provided, only [redacted]% of the RIC is owned by tax deferred organizations which may or may not qualify as pension, profit-sharing or stock bonus plans described in § 401(a) or the segregated asset accounts of life insurance companies held in connection with the variable contracts defined in § 817(d). In any event, the [redacted]% does not meet the "each shareholder" requirement of I.R.C. § 4982(f) and the exception to the imposition of the excise tax is inapplicable.

If you need further assistance, please contact the undersigned at 617/565-7858.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

DAVID N. BRODSKY
Associate Area Counsel (LMSB)

By: ______________________________
MICHELE J. GORMLEY
Senior Attorney

cc: Roland Barral
Area Counsel (LMSB)
Area 1, Financial Services

Nancy Knapp
Senior Legal Counsel (LMSB)
Area 1, Financial Services